

Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

ORIGINAL

In the Matter of:  
Simplification of the Depreciation  
Prescription Process

CC Docket No. 92-296

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MAR 10 1993

COMMENTS OF BELL ATLANTIC

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

Introduction and Summary

Bell Atlantic<sup>1</sup> commends the Commission on its effort to simplify the process by which it prescribes interstate depreciation rates.<sup>2</sup> The current process was developed when the telecommunications industry was essentially a monolithic monopoly, regulated under traditional rate of return principles and subject to relatively slow changes in technology. As the industry has changed, however, that process has become an anachronism, and should be revised to reflect the Commission's policies of promoting competition and encouraging the deployment of advanced network technology.

Under the current represcription process, estimates of the lives of carrier assets are made once every three years. This three-year lag is not responsive to rapidly changing industry conditions, and, therefore, interferes with efforts to deploy advanced technology. At the same

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<sup>1</sup> The Bell Atlantic telephone companies ("Bell Atlantic") are The Bell Telephone Company of Pennsylvania, the four Chesapeake and Potomac Telephone Companies, The Diamond State Telephone Company, and New Jersey Bell Telephone Company.

<sup>2</sup> *In the Matter of Simplification of the Depreciation Prescription Process*, Notice of Proposed Rulemaking, 8 FCC Rcd 146 (1992) ("NPRM"). While the procedures used by the FCC to prescribe depreciation rates are not binding on the states, a successful federal-level effort to simplify the process would provide a model for states to consider in establishing their own procedures.

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time, the process routinely results in the Commission substituting its judgments for those of the carriers who participate directly in the market. For these reasons, it is critically important that the Commission promptly adopt a simplified and streamlined approach to depreciation -- including the ability to obtain prescriptions more frequently than every three years.

With regard to the specific alternatives discussed in the NPRM, Bell Atlantic concurs in the comments being filed in this matter by the United States Telephone Association ("USTA").<sup>3</sup> With USTA, Bell Atlantic urges the Commission to adopt the "Price Cap Carriers" option,<sup>4</sup> as clarified in these comments and in USTA's filing. This option would be most consistent with the Commission's policy favoring prudent investment in advanced technology, and with the price cap regime applicable to major interstate carriers. It would also provide substantially greater administrative savings than any of the other alternatives.<sup>5</sup>

If, however, the Commission determines that it will not adopt the Price Cap Carriers option, then the Commission should adopt the "Basic Factor Range" option (Option A),<sup>6</sup> applied to *all* accounts, as explained in USTA's comments. This approach is more consistent with the Commission's policies favoring competition and technological advances than the current process. It would not, however, generate administrative savings as large as those available under the Price Cap Carriers option.

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<sup>3</sup> In the event of any divergence between USTA's comments and the comments set out here, these comments represent Bell Atlantic's views.

<sup>4</sup> NPRM, ¶¶ 39-43.

<sup>5</sup> See USTA Comments.

<sup>6</sup> See NPRM at ¶¶ 13-20.

The Commission should not adopt the "Depreciation Schedule" option.<sup>7</sup> Far from simplifying the depreciation process, this option appears to increase carriers' accounting burdens associated with depreciation, and to rely heavily on backward-looking, historical data to estimate the *future* useful lives of carrier assets.

I. **The Commission Should Simplify And Reform The Depreciation Prescription Process.**

A. **The Current Depreciation Prescription Process Needs Improvement.**

The purpose of depreciation is to recognize the consumption of an asset's value over time. From an investor perspective, depreciation represents the return of the investment made in an asset. From an accounting perspective, depreciation is an application of the "matching" principle under which expenses (the consumption of the asset) are matched with revenues (from services produced using the asset).

While the basic concept of depreciation is simple, its application has become shrouded in a cloud of technical jargon and mathematical complexity. Discussions of depreciation today involve "graduation techniques," "generation arrangements," "projection lives," and other concepts that only a few experts claim fully to understand. The purpose of these arcana, however, is simply to try to estimate how much longer existing assets will remain productive -- a judgment inherently subject to considerable uncertainty.

Under rate base rate of return regulation, changes in depreciation led directly to changes in service rates, leading to intense debate over the accuracy of the forecasts of asset lives on which depreciation rates were based. The result has been a process where estimates have been

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<sup>7</sup> See NPRM at ¶¶ 26-29.

derived with elaborate precision, but, in retrospect, limited accuracy. Every three years, depreciation experts use "twenty-twenty hindsight" to correct the errors made three years earlier. Yet each effort at correction inevitably creates the need for more corrections in the future.

The best evidence of this continuing problem is the intractable nature of carriers' reserve deficiencies. The Commission's Staff has required an annual "theoretical reserve" study, which, as of 1992, showed a continuing reserve deficiency of \$845,000,000 for Bell Atlantic alone.<sup>8</sup> A more specific example is the Commission's treatment of switching accounts, as the technology of choice evolved from step-by-step to crossbar to analog electronic (now being replaced by digital electronic switches). The consistent pattern was an over-estimation of the productive life of the assets -- and a correspondingly low depreciation rate -- followed by the need for a major correction in depreciation levels as the true, shorter lives of the assets became clear.<sup>9</sup>

The Commission has not ignored this problem over the years. To the contrary, both Docket No. 20188<sup>10</sup> and the Reserve Deficiency Amortization Docket<sup>11</sup> led to improvements

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<sup>8</sup> See Letter from F. Franklin (FCC) to S. Reiter (Bell Atlantic) dated June 22, 1992. Bell Atlantic's own estimates show an even greater deficiency than reflected in the Staff's study.

<sup>9</sup> For example, for C&P of Virginia, the service life of step-by-step switches was reduced from twenty-five (25) years to nine (9) years in represcriptions between 1960 and 1978; the service life of cross-bar switches was reduced from twenty-six (26) years to eleven (11) years in represcriptions between 1970 and 1980; and the service life of analog electronic switches was reduced from thirty-three (33) years to only eight (8) years in represcriptions between 1978 and 1992. This experience has been repeated in other major accounts as well.

<sup>10</sup> Report and Order, *In the Matter of Amendment of Part 31 (Uniform System of Accounts for Class A and Class B Telephone Companies) so as to permit depreciable property to be placed in groups comprised of units with the expected equal for depreciation under the straight-line method*, Docket No. 20188 (December 5, 1980) ("Docket 20188").

<sup>11</sup> *In the Matter of Amortization of Depreciation Reserve Imbalances of Local Exchange Carriers*, 3 FCC Rcd 984 at ¶ 21 (1988).

in the depreciation process. However, the underlying difficulty -- the need to estimate future plant lives in the context of rapidly changing industry conditions -- remains.

**B.     The Commission Has The Legal Authority To Adopt A Reasonable And Flexible Approach To Depreciation Represcriptions.**

One of the key difficulties with the Commission's current approach to depreciation is that the process has bogged down into an exercise in false precision. Reams of data are collected and analyzed, but the most critical variables affecting the remaining lives of a carrier's existing assets -- the availability of new technology and the development of competition in the marketplace -- are simply not susceptible to detailed mathematical calculation.

The Commission recognized long ago that it is not possible to determine the "correct" amount of depreciation for any asset or any account with any real accuracy:

"'There is no regularity in the development of depreciation. It does not proceed in accordance with any mathematical law. ... [E]ven when it is known that there has been some lessening of service life within the year, it is *never* possible to determine with accuracy what percentage of the unit's service life has, in fact, been so consumed.'"<sup>12</sup>

By the same token, the courts have held that the Commission has adequate authority under the Communications Act to deal with the inherent uncertainties of the depreciation process and to develop flexible and forward-looking practices for prescribing depreciation rates. Specifically, the Court of Appeals has held that it will not set aside the Commission's decisions regarding depreciation rates as long as those decisions fall within a broad "zone of reasonableness":

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<sup>12</sup> Docket 20188, *supra*, quoting *United Railways & Elec. Co. v. West*, 280 U.S. 234, 262 (1930) (Brandeis, J.) (emphasis added).

"This court *must* affirm the depreciation rates set by the FCC as long as they fall within a 'zone of reasonableness.' Depreciation rates will be upheld if the Commission has articulated 'some rational connection between the facts found, supported by substantial evidence, and the action which it took.'"<sup>13</sup>

Rapid developments in technology and an explosion of new competition in major telecommunications markets make it impossible to determine precisely what a carrier's theoretically "correct" depreciation rates are.<sup>14</sup> In these circumstances, the Commission should use its broad legal authority to establish procedures under which depreciation rates are determined, to the greatest extent possible, by the operation of market forces and the impact of technological change.

## **II. The Commission Should Adopt The Price Cap Carriers Option, As Clarified Here And In USTA's Comments.**

Under the Price Cap Carriers option, carriers subject to the Commission's price cap rules would file proposed depreciation rates, along with underlying information supporting those rates, with the Commission. The Commission would then give public notice of the carriers' proposed rates and, after receiving comments, prescribe depreciation rates for the carrier.<sup>15</sup>

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<sup>13</sup> *Southern Bell Tel. & Tel. Co. v. FCC*, 781 F.2d 209, 214 (D.C. Cir. 1986) (emphasis added, citations omitted).

<sup>14</sup> For example, the useful life of analog switches will be determined by factors such as the efficiencies available from digital switching and transmission equipment and from increasing customer demands for services that are based on end-to-end digital technology. These factors cannot be estimated with great precision. As a result, the fact that an analog switch can physically continue to function for two decades, and the fact that some recently retired analog switches may have been in service for that long, are of little value in estimating the remaining useful lives of analog switches that have not yet been retired, and, therefore, of little value in setting a reasonable depreciation rate for analog switches.

<sup>15</sup> NPRM, ¶¶ 40-43.

USTA's comments provide useful clarifications to this option, in which Bell Atlantic concurs. Carriers would continue to use the same basic depreciation methodology used today -- Equal Life Group using the Remaining Life formula. Key information would be included in the Commission's public notice -- just like today -- to ensure that meaningful comments can be made on a carrier's proposals.<sup>16</sup> The information provided by the carrier, along with any comments, would enable the Commission to determine the reasonableness of the carrier's proposed rates.<sup>17</sup>

The Commission could improve and streamline the Price Cap Carriers option by adopting a set of requirements and presumptions to govern its evaluation of proposed depreciation rates. Establishing such requirements and presumptions would be consistent with the structure of the Commission's price cap procedures: if a proposed set of depreciation rates complies with the presumptions, the Commission would prescribe those rates, absent a strong showing in the comments that they are unreasonable.<sup>18</sup> At the same time, a proposed set of depreciation rates that does not comply with the presumptions would not be accepted by the Commission without a substantial, detailed justification by the carrier. Depreciation rates that did not meet the

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<sup>16</sup> See USTA Comments. Carriers' filings would include, for example, estimates of life and salvage, reserves, current and proposed depreciation rates by account, and accrual changes, along with a letter of explanation.

<sup>17</sup> A judgment that the carrier's proposals are *reasonable* -- not that they are mathematically correct to the *n*th decimal place -- is all that is required under the Communications Act. See *Southern Bell Tel. & Tel. Co.*, *supra*.

<sup>18</sup> For a carrier to receive the benefit of a presumption that its proposed depreciation rates are reasonable, the Commission could require, for example, that the carrier provide a certification from the carrier's independent certified public accountants that the proposed rates comply with Generally Accepted Accounting Principles ("GAAP") and that the carrier will not seek to increase its price cap index to reflect higher depreciation expense, even if that expense pushes a carrier's return below the price cap "formula adjustment mark." The Commission could also consider establishing a presumption that changes in a carrier's account-by-account depreciation rates are reasonable as long as the overall impact on the carrier's composite depreciation rate falls within a broad, but not unlimited, range.

presumptions would only be accepted if the carrier provided the full justification and documentation required today.<sup>19</sup>

The simplification of the process that would result from using a set of requirements and presumptions would make it possible for the Commission to make revisions to a carrier's depreciation rates on an annual basis, as opposed to once every three years as under the current system. Adjusting a carrier's depreciation rates more rapidly will become increasingly important as competition grows and new technologies are developed and deployed at an accelerated rate.

### **III. The Price Cap Carriers Option Will Not Allow Carriers To Manipulate Their Earnings Or Depreciation Rates.**

The NPRM expressed concern that price cap carriers might increase their proposed depreciation rates in order to avoid the obligation to share earnings that would exist under current depreciation rates.<sup>20</sup> There is no basis for this concern.

First, a carrier could only avoid sharing obligations by lowering its reported earnings. While this might seem a logical step from the narrow perspective of the Commission's price cap rules, those lower earnings would also be reflected on the carrier's external financial reports.

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<sup>19</sup> Depreciation rates are reasonable if they do not lead to exorbitant prices for customers and do not confiscate the carrier's property. *Id.* See also *Permian Basin Area Rate Cases*, 390 U.S. 747, 767-770 (1968). A reasonable set of requirements and presumptions -- including a presumption that carriers increasing their depreciation rates under this option cannot base price cap increases on the resulting increase in depreciation expense -- would guarantee that increases in depreciation rates do not lead to increases in customer prices. At the same time, a carrier could not complain that depreciation rates it had itself proposed were confiscatory. As a result, the Price Cap Carriers option, clarified as discussed above, would strike a fair and reasonable balance between shareholder and ratepayer interests, as required by the Communications Act. See *Southern Bell Tel. & Tel. Co.*, *supra*, 781 F.2d at 214-15.

<sup>20</sup> See NPRM at ¶ 40.



Any unreasonable or unjustified increase in depreciation expense, therefore, would fly in the face of the responsibility of the carrier's management to provide earnings for shareholders.

Moreover, a given asset can only be depreciated once. As a result, increased depreciation expense in one year leads to a lower rate base and expenses -- and, therefore, higher reported earnings, with concomitant sharing obligations -- in future years. While this impact could be reduced if the carrier continued to invest significantly in its network, the recognized need to upgrade the nation's telecommunications infrastructure<sup>21</sup> suggests that reinvestment should be encouraged, not viewed with suspicion.<sup>22</sup>

To the extent that the Commission remains concerned about the prospect of manipulation of depreciation rates, however, two requirements would address that concern. First, while allowing annual filings is important, as discussed above, it would also be reasonable to limit proposals for depreciation prescriptions to one per calendar year. Second, the Commission should require that the filing be made in the first quarter of the year. These requirements would eliminate any realistic ability on the carriers' part to use proposed depreciation rates to manipulate their earnings, because carriers could not adjust their depreciation expenses late in the year to offset earnings that would lead to sharing obligations.

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<sup>21</sup> See, e.g., *Telephone Company-Cable Television Cross-Ownership Rules*, Sec. 63.54-63.58, *Second Report and Order, Recommendation to Congress, and Second Further Notice of Proposed Rulemaking*, 7 FCC Rcd 5781 at ¶ 9 (1992).

<sup>22</sup> Additional assurances that a carrier's proposed depreciation rates are reasonable would be gained by requiring that the carrier's independent certified public accountant certify that the proposed depreciation rates are consistent with GAAP, as suggested above. See note 18, *supra*. Unreasonably high depreciation rates, not related to realistic assessments of the remaining lives of a carrier's assets, would not pass this test.

**IV. The Price Cap Carriers Option Allows For Adequate Notice To State Commissions.**

The NPRM asks whether the Price Cap Carriers option is consistent with the provisions of the Communications Act that require notice of proposed depreciation rates to affected state commissions.<sup>23</sup> The Price Cap Carriers option is fully consistent with these requirements.

The Act requires that the Commission "notify" affected state commissions and give each affected commission "reasonable opportunity ... to present its views." The Price Cap Carriers option would provide such notice and opportunity to comment. Also, as noted in USTA's comments, if the Commission believes that special notice procedures should apply to state regulators, price cap carriers could be required to provide copies of their filings to state regulators at the same time those filings are provided to the Commission. This would ensure that affected state regulators have timely, actual notice of the carriers' filings.<sup>24</sup>

**V. If The Commission Does Not Adopt The Price Cap Carriers Option As Described Above, It Should Adopt The Basic Factor Range Option As Described In USTA's Comments.**

For the reasons described above, the Price Cap Carriers option is the best way to simplify the Commission's depreciation procedures. If, however, the Commission concludes that

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<sup>23</sup> See NPRM at ¶¶ 41-42.

<sup>24</sup> The special notice requirements for state regulatory bodies in Section 220(i) were included in the Act before the Supreme Court decided *Louisiana PSC v. FCC*, 476 U.S. 355 (1986), which held that state regulators were not bound by the Commission's depreciation prescriptions. The result in *Louisiana*, therefore, attenuates the rationale underlying the notice provisions of Section 220(i), because state commissions are not affected by this Commission's decisions on depreciation to the extent that they were before that decision. As a result, the Commission may safely rely on normal notice-and-comment procedures for receiving state-level input.

it will not adopt that option, it should adopt the Basic Factor Range option,<sup>25</sup> as clarified in USTA's comments. Bell Atlantic also agrees with USTA that the Basic Factor Range option will not result in significant administrative savings unless it is applied to *all* of a carrier's accounts.

The Commission should not limit this option to small, stable accounts. While continuing the current process for all but these small accounts might generate some minimal administrative savings, this approach will do nothing to advance the overall policy of allowing an individual carrier's judgments of the impacts of competition and technology on that carrier's business -- rather than the Commission's regulatory *fiat* -- to determine appropriate depreciation rates. Indeed, exempting the major accounts most affected by technology and competition, as suggested in the NPRM, would eliminate most of the possible benefit of this option.

If the Basic Factor Range option is selected, it should be implemented promptly, and in any event no later than 1994, because delays (or long phase-in periods) could significantly disadvantage regulated companies in the marketplace. For smaller and more stable accounts, the initial range should be based on the range of factors embodied in currently prescribed depreciation rates, plus or minus two standard deviations, as a reasonable starting point. For other accounts, including those most affected by new technology, the basis for the initial range should be the estimates of the relevant factors included in each carrier's presentation to the Commission Staff in connection with that carrier's most recent represetation.

Under this option, the ranges from which a carrier may choose "basic factors" must be broad enough to allow the carrier to exercise its best individual judgment about the impact of

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<sup>25</sup> See NPRM at ¶¶ 13-20. Bell Atlantic believes that the Basic Factor Range option (Option A) is preferable, from a technical perspective, to the Depreciation Rate Range option (Option B).

competition and new technology on its business. In addition to being reasonable and readily available, the criteria outlined above for establishing initial ranges meet this concern, and should be adopted for this reason as well.<sup>26</sup>

### Conclusion

For the reasons stated above, the Commission should simplify its depreciation prescription process by adopting the Price Cap Carriers option, as clarified above and in USTA's comments. If the Commission determines that it will not adopt that option, it should adopt the Basic Factor Range option, applied to all of a carrier's accounts.

Respectfully submitted,



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March 10, 1993

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<sup>26</sup> The Commission should not adopt the Depreciation Schedule option (Option C). See NPRM at ¶¶ 26-28. This option does not appear to simplify the depreciation process; to the contrary, it appears to *increase* carriers' accounting burdens associated with depreciation. At the same time, it seems to rely quite heavily, if not entirely, on backward-looking, historical data to estimate the *future* useful lives of carrier assets, effectively guaranteeing that those estimates will be inaccurate and, most likely, unduly long in light of the rapid technological change and growing competition that characterize the telecommunications industry today.

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing "Comments of Bell Atlantic" was served this 10th day of March, 1993 by first class mail, postage prepaid, to the parties on the attached list.

  
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